

Notice of Proposed Rulemaking and Notice of Public Hearing

Compensatory Stock Options Under Section 482

REG-106359-02

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations that provide guidance regarding the application of the rules of section 482 governing qualified cost sharing arrangements. These proposed regulations provide guidance regarding the treatment of stock-based compensation for purposes of the rules governing qualified cost sharing arrangements and for purposes of the comparability factors to be considered under the comparable profits method. This document also provides notice of a public hearing on these proposed regulations.

DATES: Written or electronic comments must be received by October 28, 2002. Requests to speak and outlines of topics to be discussed at the public hearing scheduled for November 20, 2002, must be received by October 30, 2002.

ADDRESSES: Send submissions to: CC:ITA:RU (REG-106359-02), room 5226, Internal Revenue Service, POB 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered between the hours of 8 a.m. and 5 p.m. to CC:ITA:RU (REG-106359-02), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC. Alternatively, taxpayers may submit comments electronically directly to the IRS Internet site at www.irs.gov/regs. The public hearing will be held in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC.

FOR FURTHER INFORMATION CONTACT: Concerning the regulations, Douglas Giblen, (202) 874-1490; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, LaNita Van Dyke, (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S, Washington, DC 20224. Comments on the collection of information should be received by September 27, 2002. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the Internal Revenue Service, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information requirements are in proposed §§ 1.482–7(d)(2)(iii)(B) and 1.482–7(j)(2)(i)(F). This information is required by the IRS to monitor compliance with the federal tax rules for determining stock-based compensation costs related to intangible development to be shared among controlled participants in qualified cost sharing arrangements. The likely respondents are taxpayers who enter into these arrangements. Responses to this collection of information are required to determine these taxpayers' proper shares of stock-based compensation costs incurred with respect to these arrangements.

Section 1.482–7(d)(2)(iii)(B) of the proposed regulations provides that controlled participants may elect an alternative method of measurement of certain stock-based compensation by clearly referring to the election in the written cost sharing agreement required under existing regulations or by amending a cost sharing agreement already in effect to refer to the election. Section 1.482–7(j)(2)(i)(F) requires controlled participants to maintain documentation necessary to establish the amount taken into account as operating expenses attributable to stock-based compensation, including the method of measurement and timing used in computing that amount, and the data, as of the date of grant, used to identify stock-based compensation related to the development of intangibles.

Estimated total annual reporting and/or recordkeeping burden: 2,000 hours.

Estimated average annual burden hours per respondent and/or recordkeeper: The estimated annual burden per respondent

varies from 2 hours to 7 hours, depending on individual circumstances, with an estimated average of 4 hours.

Estimated number of respondents and/or recordkeepers: 500.

Estimated frequency of responses: Annually.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

Section 482 of the Internal Revenue Code generally provides that the Secretary may allocate gross income, deductions and credits between or among two or more taxpayers owned or controlled by the same interests in order to prevent evasion of taxes or clearly to reflect income. On July 8, 1994, Treasury and the IRS published in the **Federal Register** (59 FR 34988) final regulations (T.D. 8552, 1994–2 C.B. 93) under section 482 in areas other than cost sharing. On December 20, 1995, Treasury and the IRS published in the **Federal Register** (60 FR 65553) final cost sharing regulations (T.D. 8632, 1996–1 C.B. 85), effective for taxable years beginning on or after January 1, 1996. Amendments to T.D. 8632 were published in the **Federal Register** on May 13, 1996, at 61 FR 21955 (T.D. 8670, 1996–1 C.B. 99), and on January 3, 2001, at 66 FR 280 (T.D. 8930, 2001–1 C.B. 433).

The 1994 final regulations under section 482 contain general provisions at § 1.482–1 describing the arm's length standard and the best method rule. The final cost sharing regulations at § 1.482–7 generally require that controlled participants in a qualified cost sharing arrangement share intangible development costs in proportion to their shares of the reasonably anticipated benefits attributable to the development of the intangibles covered by the arrangement. These proposed regulations clarify that stock-based compensation is taken into account in determining

the operating expenses treated as a controlled participant's intangible development costs for purposes of the cost sharing provisions; provide rules for measuring the cost associated with stock-based compensation; clarify that the utilization and treatment of stock-based compensation is appropriately taken into account as a comparability factor for purposes of the comparable profits method under § 1.482–5; and clarify the coordination of the cost sharing rules of § 1.482–7 with the arm's length standard as set forth in § 1.482–1.

Explanation of Provisions

Overview

The Tax Reform Act of 1986, Public Law 99–514, 100 Stat. 2085, 2561 *et seq.* (reprinted at 1986–3 C.B. (Vol 1) 1, 478) (the Act), amended section 482 to require that consideration for intangible property transferred in a controlled transaction be commensurate with the income attributable to the intangible. The legislative history of the Act indicated that in adding this commensurate with income standard to section 482, Congress did not intend to preclude the use of *bona fide* research and development cost sharing arrangements as an appropriate method of allocating income attributable to intangibles among related parties, “if and to the extent such agreements are consistent with the purpose of this provision that the income allocated among the parties reasonably reflect the actual economic activity undertaken by each. Under such a *bona fide* cost-sharing arrangement, the cost-sharer would be expected to bear its portion of all research and development costs. . . .” H.R. Rep. No. 99–841, at II–638 (1986) (the Conference Report).

The Conference Report recommended that the IRS conduct a comprehensive study and consider whether the regulations under section 482 (issued in 1968) should be modified in any respect. In response to this directive, on October 18, 1988, Treasury and the IRS issued a study of inter-company pricing (the White Paper), published as Notice 88–123, 1988–2 C.B. 458. With respect to cost sharing arrangements, the White Paper observed that Congress intended such arrangements to produce results consistent with the purposes of the commensurate with income standard in section 482, and in particular that allocations of income among the par-

ticipants reasonably reflect the participants' respective economic activity. 1988-2 C.B. at 459, 495. The White Paper further observed that Congress intended that Treasury and the IRS apply and interpret the commensurate with income standard consistently with the arm's length standard. 1988-2 C.B. at 458, 477.

Section 1.482-1 of the 1994 final regulations provides that a controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances. A method selected under the best method rule is used to determine whether a controlled transaction produces an arm's length result. The regulations reference §§ 1.482-2 through 1.482-6 as providing specific methods to be used in this determination.

Section 1.482-7 of the 1995 final regulations implements the commensurate with income standard in the context of cost sharing arrangements. The final cost sharing regulations require that controlled participants in a qualified cost sharing arrangement share all costs incurred that are related to the development of intangibles in proportion to their shares of the reasonably anticipated benefits attributable to that development. Section 1.482-7(d)(1) defines these intangible development costs as including operating expenses as defined in § 1.482-5(d)(3), other than depreciation or amortization, plus an arm's length rental charge determined under § 1.482-2(c) for the use of any tangible property made available to the qualified cost sharing arrangement. Section 1.482-5(d)(3) defines operating expenses, for purposes of the comparable profits method under section 482, as including all expenses not included in cost of goods sold except for interest expense, foreign and domestic income taxes, and any other expenses not related to the operation of the relevant business activity. In the context of cost sharing, the relevant business activity is the development of intangibles covered by the cost sharing arrangement.

Since the promulgation of the final cost sharing regulations in 1995, the issue has been raised whether operating expenses within the meaning of § 1.482-7(d)(1) include compensation provided by a controlled participant in the form of stock

options. Related questions have been posed in this context regarding the interaction between the arm's length standard and the cost sharing regulations.

These proposed regulations amend the final regulations to clarify that stock-based compensation must be taken into account in determining operating expenses under § 1.482-7(d)(1) and to provide rules for measuring stock-based compensation costs. These proposed regulations also clarify that stock-based compensation should be taken into account in comparability determinations pursuant to the comparable profits method under § 1.482-5. Finally, the proposed regulations amend the final regulations to include express provisions to coordinate the cost sharing rules of § 1.482-7 with the arm's length standard as set forth in § 1.482-1.

Inclusion of Stock-Based Compensation in Intangible Development Costs

The proposed regulations provide that in determining a controlled participant's operating expenses within the meaning of § 1.482-7(d)(1), all compensation, including stock-based compensation, must be taken into account. The proposed regulations also provide rules for measuring the operating expenses attributable to stock-based compensation.

The definition of stock-based compensation for purposes of these proposed regulations is broad, comprising any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, stock options, or rights in (or determined by reference to) such instruments or options, regardless of whether the compensation ultimately is settled in the form of cash, stock, or other property. Thus, these proposed regulations are intended to reach such forms of compensation as restricted stock, nonstatutory stock options, statutory stock options (incentive stock options described in section 422(b) and options granted under an employee stock purchase plan described in section 423(b)), stock appreciation rights, and phantom stock. Statutory stock options are within the scope of the definition regardless of whether the employer is entitled to an income tax deduction with respect to those options.

The proposed regulations provide that the determination of whether stock-based compensation is related to the development of intangibles covered by the qualified cost sharing arrangement is to be made as of the date the stock-based compensation is granted. For example, controlled participants must share the costs attributable to stock-based compensation that is granted to an employee who, at the time of grant, is performing research services related to the qualified cost sharing arrangement. Treasury and the IRS believe that this rule appropriately identifies the stock-based compensation to be shared because the grant of compensation generally is the economic event most closely associated in time with the services being compensated. Because a controlled participant may choose whether to provide stock-based or cash compensation, this rule also promotes neutrality of treatment as among various forms of compensation. Finally, because the grant-date identification rule applies irrespective of the method used by the controlled participant to measure or determine the timing of inclusion of stock-based compensation in the intangible development costs to be shared, the rule ensures that the same items of stock-based compensation will be taken into account under any method, thus promoting neutrality in the choice of measurement method afforded by the proposed regulations.

In applying the grant-date identification rule in cases where a stock option is repriced or otherwise modified, the rules of section 424(h) and related regulations will be used to determine whether the grant of a new stock option has occurred.

Treasury and the IRS recognize that tax and other accounting principles permit the cost associated with stock-based compensation to be measured and taken into account as of different points in time and under various methodologies for different purposes. For example, for general income tax purposes, the amount of compensation taxed to an employee and deductible by an employer upon exercise of a stock option not governed by sections 421-424 (commonly referred to as a nonstatutory stock option) generally is measured by the "spread" between the option price and the fair market value of the underlying stock at the date of exercise. See §§ 83(a), 83(h), 1.83-1(a)(1), 1.83-6(a)(1).

For various other tax purposes, however, the IRS has adopted modified versions of economic pricing models, such as the Black-Scholes model, for valuing stock options at specific points in time prior to exercise. See Rev. Proc. 98-34, 1998-1 C.B. 983 (estate and gift tax valuation); Rev. Proc. 2002-13, 2002-8 I.R.B. 549, as modified by Rev. Proc. 2002-45, 2002-27 I.R.B. 40 (measurement of stock-option-based golden parachute payments under sections 280G and 4999). Pricing models also have been adopted in the context of financial accounting. The Financial Accounting Standards Board (FASB) refers to pricing models for measurement of the stock-based compensation expense that a company is required to report at "fair value," either as a charge to income or, at the company's option, in a *pro forma* footnote disclosure. See FASB Statement 123, Accounting for Stock-Based Compensation (October 1995).

Generally accepted pricing models can be applied at the date of grant to estimate the economic cost of a stock option to the issuer. General support for the use of economic measures of cost in the transfer pricing context may be found in the legislative history of the commensurate with income standard and in the White Paper, which state that to be consistent with the commensurate with income standard, cost sharing arrangements must "reflect the actual economic activity" of participants. Conference Report at II-638 and White Paper at 1988-2 C.B. 495.

In establishing rules for measurement of the operating expenses attributable to stock-based compensation for cost sharing purposes, Treasury and the IRS believe that due regard must be given to the emphasis placed on economic factors in the legislative history of the commensurate with income standard and in the White Paper. Treasury and the IRS also recognize the importance of providing rules that are administrable.

The proposed regulations prescribe a general rule of measurement based primarily on the amount and timing of the income tax deduction associated with stock-based compensation, while in certain cases permitting controlled participants in a qualified cost sharing arrangement to elect a rule of measurement with respect to stock options based on the amount and timing of the fair value of the option that

is required to be computed for purposes of financial accounting in accordance with United States generally accepted accounting principles (U.S. GAAP).

To provide for uniform measurement of the cost associated with both statutory and nonstatutory stock options, the general deduction-based measurement rule is applied as if section 421 did not apply upon the exercise of a statutory stock option. Thus, although section 421 generally disallows compensation deductions with respect to the exercise of statutory stock options except in the case of certain disqualifying dispositions, the proposed regulations treat the exercise of a statutory stock option as giving rise to a deduction for purposes of the deduction-based measurement rule. Consequently, the operating expense with respect to all stock options, whether statutory or nonstatutory, generally will be measured by the "spread" and taken into account as of the date the stock option is exercised.

To place a foreign controlled participant on an equal footing with a United States controlled participant, an amount is treated as deductible by a foreign controlled participant, solely for purposes of the general deduction-based measurement rule, as if the amount were paid or incurred by a United States taxpayer, even if the foreign controlled participant is not subject to United States taxing jurisdiction and so would not otherwise be entitled to a deduction under United States income tax law.

Solely for purposes of the general deduction-based measurement rule, any item of stock-based compensation that is eligible to be exercised and that remains outstanding on the expiration or termination of a qualified cost sharing arrangement will be treated as being exercised immediately before the expiration or termination, provided that the fair market value of the underlying stock at that time exceeds the price at which the stock-based compensation is exercisable. The result of this treatment is that the excess of the fair market value of the underlying stock over the price at which the stock-based compensation is exercisable is taken into account as an operating expense for the taxable year in which the qualified cost sharing arrangement expires or terminates. This special rule would apply, for example, in the case of a currently exercis-

able statutory stock option or a substantially vested nonstatutory stock option where the fair market value of the underlying stock exceeds the option price at the time the qualified cost sharing arrangement is terminated. The rule ensures that controlled participants take into account for cost sharing purposes all stock-based compensation that is attributable to the development of intangibles and has become exercisable during the term of the cost sharing arrangement. In cases where significant amounts of stock-based compensation have been granted, but are not exercisable at the time of the termination of the arrangement, the IRS anticipates that factual issues regarding the termination of the qualified cost sharing arrangement will arise if the arrangement is reinstated.

A similar rule applies if, during the term of the qualified cost sharing arrangement, a newly granted stock option is determined to result from a repricing or other modification of another stock option and is not related to the development of intangibles at the time of the modification. In this situation, an amount is taken into account for purposes of the general deduction-based measurement rule as if the original stock option had been exercised immediately before the modification.

The proposed regulations permit an elective method of measurement and timing with respect to options on publicly traded stock of companies subject to financial reporting under U.S. GAAP, provided that the stock is traded on a United States securities market.

Under the election, the amount of the operating expense associated with compensatory stock options is their "fair value," generally measured by reference to economic pricing models as of the date of grant, as reflected either as a charge against income or as a footnote disclosure in the company's audited financial statements, in compliance with current U.S. GAAP. Where the election is made with respect to stock in a company that does not take stock-based compensation expense as a charge against income for financial accounting purposes but rather chooses, as permitted by current U.S. GAAP (for example, FASB Statement 123), to disclose such compensation in a footnote to the financial statements, stock-based compensation is taken into account

in the same amount, and as of the same time, as the *pro forma* fair value figures reflected in the footnote.

The election to measure the operating expense associated with compensatory stock options in accordance with financial accounting rules must be clearly referenced in the written cost sharing agreement required under § 1.482-7(b)(4) and must bind all controlled participants. A transition rule permits controlled participants to amend pre-existing cost sharing agreements not later than the latest due date (without regard to extensions) for an income tax return of a controlled participant for the first taxable year beginning after the effective date of final regulations incorporating this rule.

The proposed regulations contain consistency rules to ensure that all controlled participants in a qualified cost sharing arrangement normally will use the same method of measurement for all options on publicly traded stock with respect to that arrangement. Once a method of measurement has been adopted with respect to stock options granted in a taxable year following the effective date of the proposed regulations, the method of measurement may not be changed for those stock options. With respect to subsequently granted stock options to which the transition rule does not apply, the proposed regulations provide that a method of measurement different from that adopted following the effective date of the proposed regulations may be adopted only with the consent of the Commissioner.

To ensure that taxpayers maintain documentation supporting all amounts taken into account as operating expenses attributable to stock-based compensation, these proposed regulations add to the documentation requirements of § 1.482-7(j)(2)(i) an item specifically relating to stock-based compensation.

Treatment of Stock-Based Compensation Under Other Provisions

The treatment of stock-based compensation as a cost or operating expense for purposes of the transfer pricing of services and for purposes of applying the comparable profits method will be considered by Treasury and the IRS in a separate regulation project. Accordingly, these regulations do not propose amendments to the definitions of cost or operating expense in

§ 1.482-2(b) or § 1.482-5(d)(3). However, these proposed regulations amend § 1.482-5(c)(2)(iv) to clarify that in applying the comparable profits method, material differences among the tested party and uncontrolled comparables with respect to the utilization or treatment of stock-based compensation are an appropriate basis for comparability adjustments.

Coordination of Cost Sharing With the Arm's Length Standard

These proposed regulations add express provisions coordinating the cost sharing rules of § 1.482-7 with the arm's length standard as set forth in § 1.482-1. New § 1.482-7(a)(3) clarifies that in order for a qualified cost sharing arrangement to produce results consistent with an arm's length result within the meaning of § 1.482-1(b)(1), all requirements of § 1.482-7 must be met, including the requirement that each controlled participant's share of intangible development costs equal its share of reasonably anticipated benefits attributable to the development of intangibles. The proposed regulations also make amendments to § 1.482-1 to clarify that § 1.482-7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result, and to clarify that under the best method rule, the provisions of § 1.482-7 set forth the applicable method with respect to qualified cost sharing arrangements.

Through these new provisions, Treasury and the IRS intend to clarify that all of the specific rules necessary to the determination of costs, reasonably anticipated benefits and other aspects of qualified cost sharing arrangements are either contained or cross-referenced within § 1.482-7. Thus, for example, regarding buy-in payments with respect to pre-existing intangibles made available to qualified cost sharing arrangements, §§ 1.482-7(a)(2) and 1.482-7(g) cross-reference various other sections of the regulations under section 482. For the determination of reasonably anticipated benefits, § 1.482-7(f)(3) expressly requires that certain comparability factors described in § 1.482-1(c)(2)(ii) under the best method rule be considered. With respect to identification of the costs to be shared, the rules are contained within § 1.482-7(d)(1), which refers to "all" in-

tangible development costs and cross-references the definition of operating expenses in § 1.482-5(d)(3) and the provisions of § 1.482-2(c) governing determination of arm's length rental charges for tangible property. The § 1.482-7(d)(1) definition of intangible development costs is supplemented by the provisions of § 1.482-7(c)(2), which cross-references the provisions of § 1.482-4(f)(3)(iii) to determine arm's length consideration for research assistance performed by a controlled taxpayer that is not a controlled participant.

Proposed Effective Date

These regulations are proposed to apply to stock-based compensation granted in taxable years beginning on or after the date these regulations are published as a Treasury Decision promulgating final regulations in the **Federal Register**. Notwithstanding this prospective effective date, Treasury and the IRS intend that taxpayers may rely on these proposed regulations until the effective date of the final regulations. No inference is intended with respect to the treatment of stock-based compensation granted in taxable years beginning before the effective date of the final regulations.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collections of information in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based upon the fact that few small entities are expected to enter into qualified cost sharing arrangements involving stock-based compensation, and that for those who do, the burdens imposed under §§ 1.482-7(d)(2)(iii)(B) and 1.482-7(j)(2)(i)(F) will be minimal. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f), this notice of proposed rulemaking will be submitted to the Chief Counsel for Advocacy

of the Small Business Administration for comment on its impact on small business.

Comments and Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. Treasury and the IRS specifically request comments on the clarity of the proposed regulations and how they may be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for October 21, 2002, at 10 a.m., in Room 4718, Internal Revenue Building, 1111 Constitution Avenue, NW, Washington, DC. Because of access restrictions, visitors will not be admitted beyond the building lobby more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by September 30, 2002. A period of 10 minutes will be allotted to each person for making comments.

An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these proposed regulations is Douglas Giblen of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury and the IRS participated in their development.

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Proposed Amendments to the Regulations

Accordingly, 26 CFR Part 1 is proposed to be amended as follows:

PART 1 — INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Sections 1.482-1, 1.482-5 and 1.482-7 also issued under 26 U.S.C. 482. * * *

Par. 2. Section 1.482-0 is amended by:

1. Redesignating the entry for § 1.482-7(a)(3) as the caption for § 1.482-7(a)(4).

2. Adding a new entry for § 1.482-7(a)(3).

3. Redesignating the entry for § 1.482-7(d)(2) as the caption for § 1.482-7(d)(3).

4. Adding new entries for § 1.482-7(d)(2).

The additions and revisions read as follows:

§ 1.482-0 *Outline of regulations under section 482.*

* * * * *

§ 1.482-7 *Sharing of costs.*

(a) In general.

* * * * *

(3) Coordination with § 1.482-1.

(4) Cross references.

* * * * *

(d) Costs.

* * * * *

(2) Stock-based compensation.

(i) In general.

(ii) Identification of stock-based compensation related to intangible development.

(iii) Measurement and timing of stock-based compensation expense.

(A) In general.

(1) Transfers to which section 421 applies.

(2) Deductions of foreign controlled participants.

(3) Modification of stock option.

(4) Expiration or termination of qualified cost sharing arrangement.

(B) Election with respect to options on publicly traded stock.

(C) Consistency.

(3) Examples.

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Par. 3. Section 1.482-1 is amended by:

1. Revising the sixth sentence of paragraph (a)(1).

2. Adding a sentence following the sixth sentence of paragraph (a)(1).

3. Adding a sentence at the end of paragraph (b)(2)(i).

4. Adding a sentence at the end of paragraph (c)(1).

5. Adding paragraph (j)(5).

The additions and revisions read as follows:

§ 1.482-1 *Allocation of income and deductions among taxpayers.*

(a) * * *

(1) * * * Section 1.482-7T sets forth the cost sharing provisions applicable to taxable years beginning on or after October 6, 1994, and before January 1, 1996. Section 1.482-7 sets forth the cost sharing provisions applicable to taxable years beginning on or after January 1, 1996.

* * * * *

(b) * * *

(2) * * *

(i) * * * Section 1.482-7 provides the specific method to be used to evaluate whether a qualified cost sharing arrangement produces results consistent with an arm's length result.

* * * * *

(c) * * *

(1) * * * See § 1.482-7 for the applicable method in the case of a qualified cost sharing arrangement.

* * * * *

(j) * * *

(5) The last sentences of paragraphs (b)(2)(i) and (c)(1) of this section and of paragraph (c)(2)(iv) of § 1.482-5 are effective for taxable years beginning on or after the date of publication of the Treasury Decision incorporating those sentences into final regulations in the **Federal Register**.

Par. 4. Section 1.482-5 is amended by adding a sentence to paragraph (c)(2)(iv) to read as follows:

§ 1.482-5 *Comparable profits method.*

* * * * *

(c) * * *

(2) * * *

(iv) * * * As another example, it may be appropriate to adjust the operating profit of a party to account for material differences in the utilization of or accounting for stock-based compensation (as defined by § 1.482-7(d)(2)(i)) among the tested party and comparable parties.

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Par. 5. Section 1.482-7 is amended by:

1. Redesignating paragraph (a)(3) as paragraph (a)(4).
2. Adding paragraph (a)(3).
3. Redesignating paragraph (d)(2) as paragraph (d)(3).
4. Adding paragraph (d)(2).
5. Removing the word “and” at the end of paragraph (j)(2)(i)(D).
6. Removing the period and adding a semicolon and adding the word “and” at the end of paragraph (j)(2)(i)(E).
7. Adding paragraph (j)(2)(i)(F).
8. Revising paragraph (k).

The additions and revisions read as follows:

§ 1.482–7 *Sharing of costs.*

(a) * * *

(3) *Coordination with § 1.482–1.* A qualified cost sharing arrangement produces results that are consistent with an arm’s length result within the meaning of § 1.482–1(b)(1) if, and only if, each controlled participant’s share of the costs (as determined under paragraph (d) of this section) of intangible development under the qualified cost sharing arrangement equals its share of reasonably anticipated benefits attributable to such development (as required by paragraph (a)(2) of this section) and all other requirements of this section are satisfied.

(4) *Cross references.* * * *

* * * * *

(d) * * *

(2) *Stock-based compensation.*—(i) *In general.* For purposes of this section, a controlled participant’s operating expenses include all costs attributable to compensation, including stock-based compensation. As used in this section, the term *stock-based compensation* means any compensation provided by a controlled participant to an employee or independent contractor in the form of equity instruments, options to acquire stock (stock options), or rights with respect to (or determined by reference to) equity instruments or stock options, including but not limited to property to which section 83 applies and stock options to which section 421 applies, regardless of whether ultimately settled in the form of cash, stock, or other property.

(ii) *Identification of stock-based compensation related to intangible development.* The determination of whether stock-based compensation is related to the intangible development area within the

meaning of paragraph (d)(1) of this section is made as of the date that the stock-based compensation is granted. Accordingly, all stock-based compensation that is granted during the term of the qualified cost sharing arrangement and is related at date of grant to the development of intangibles covered by the arrangement is included as an intangible development cost under paragraph (d)(1) of this section. In the case of a repricing or other modification of a stock option, the determination of whether the repricing or other modification constitutes the grant of a new stock option for purposes of this paragraph (d)(2)(ii) will be made in accordance with the rules of section 424(h) and related regulations.

(iii) *Measurement and timing of stock-based compensation expense.*—(A) *In general.* Except as otherwise provided in this paragraph (d)(2)(iii), the operating expense attributable to stock-based compensation is equal to the amount allowable to the controlled participant as a deduction for federal income tax purposes with respect to that stock-based compensation (for example, under section 83(h)) and is taken into account as an operating expense under this section for the taxable year for which the deduction is allowable.

(1) *Transfers to which section 421 applies.* Solely for purposes of this paragraph (d)(2)(iii)(A), section 421 does not apply to the transfer of stock pursuant to the exercise of an option that meets the requirements of section 422(a) or 423(a).

(2) *Deductions of foreign controlled participants.* Solely for purposes of this paragraph (d)(2)(iii)(A), an amount is treated as deductible by a foreign controlled participant otherwise not entitled to a deduction under United States income tax law as if the amount were paid or incurred by a United States taxpayer.

(3) *Modification of stock option.* Solely for purposes of this paragraph (d)(2)(iii)(A), if the repricing or other modification of a stock option is determined, under paragraph (d)(2)(ii) of this section, to constitute the grant of a new stock option not related to the development of intangibles, the stock option that is repriced or otherwise modified will be treated as being exercised immediately before the modification, provided that the stock option is then substantially vested within the meaning of § 1.83–3(b) (or, in the case of stock options to which section

421 applies, exercisable) and the fair market value of the underlying stock then exceeds the price at which the stock option is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock option immediately before the modification must be taken into account as an operating expense as of the date of the modification.

(4) *Expiration or termination of qualified cost sharing arrangement.* Solely for purposes of this paragraph (d)(2)(iii)(A), if an item of stock-based compensation related to the development of intangibles is not exercised during the term of a qualified cost sharing arrangement, that item of stock-based compensation will be treated as being exercised immediately before the expiration or termination of the qualified cost sharing arrangement, provided that the stock-based compensation is then substantially vested within the meaning of § 1.83–3(b) (or, in the case of stock options to which section 421 applies, exercisable) and the fair market value of the underlying stock then exceeds the price at which the stock-based compensation is exercisable. Accordingly, the amount of the deduction that would be allowable (or treated as allowable under this paragraph (d)(2)(iii)(A)) to the controlled participant upon exercise of the stock-based compensation must be taken into account as an operating expense as of the date of the expiration or termination of the qualified cost sharing arrangement.

(B) *Election with respect to options on publicly traded stock.* With respect to stock-based compensation in the form of options on publicly traded stock, the controlled participants in a qualified cost sharing arrangement may elect to take into account all operating expenses attributable to those stock options in the same amount, and as of the same time, as the fair value of the stock options reflected as a charge against income in audited financial statements or disclosed in footnotes to such financial statements, prepared in accordance with United States generally accepted accounting principles by or on behalf of the company issuing the publicly traded stock. As used in this section, the term *publicly traded stock* means stock that is regularly traded on an established United States securities market and is issued by a company whose financial statements are prepared in

accordance with United States generally accepted accounting principles for the taxable year. The election described in this paragraph (d)(2)(iii)(B) is made by an explicit reference to the election in the written cost sharing agreement required by paragraph (b)(4) of this section or in a written amendment to the cost sharing agreement entered into with the consent of the Commissioner pursuant to paragraph (d)(2)(iii)(C) of this section. In the case of a qualified cost sharing arrangement in existence on the effective date of this paragraph (d)(2)(iii)(B), the election must be made by written amendment to the cost sharing agreement not later than the latest due date (without regard to extensions) of a federal income tax return of any controlled participant for the first taxable year beginning after the effective date of this paragraph, and the consent of the Commissioner is not required.

(C) *Consistency.* Generally, all controlled participants in a qualified cost sharing arrangement taking options on publicly traded stock into account under paragraph (d)(2)(iii)(A) or (d)(2)(iii)(B) of this section must use that same method of measurement and timing for all options on publicly traded stock with respect to that qualified cost sharing arrangement. Controlled participants may change their method only with the consent of the Commissioner and only with respect to stock options granted during taxable years subsequent to the taxable year in which the Commissioner's consent is obtained. All controlled participants in the qualified cost sharing arrangement must join in requests for the Commissioner's consent under this paragraph. Thus, for example, if the controlled participants make the election described in paragraph (d)(2)(iii)(B) of this section upon the formation of the qualified cost sharing arrangement, the election may be revoked only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained. Similarly, if controlled participants already have granted stock options that have been or will be taken into account under the general rule of paragraph (d)(2)(iii)(A) of this section, then except in cases specified in the last sentence of paragraph (d)(2)(iii)(B)

of this section, the controlled participants may make the election described in paragraph (d)(2)(iii)(B) of this section only with the consent of the Commissioner, and the consent will apply only to stock options granted in taxable years subsequent to the taxable year in which consent is obtained.

(3) Examples. * * *

* * * * *

(j) * * *

(2) * * *

(i) * * *

(F) The amount taken into account as operating expenses attributable to stock-based compensation, including the method of measurement and timing used with respect to that amount as well as the data, as of date of grant, used to identify stock-based compensation related to the development of intangibles covered by the qualified cost sharing arrangement.

* * * * *

(k) *Effective date.* This section is generally effective for taxable years beginning on or after January 1, 1996. However, paragraphs (a)(3), (d)(2), and (j)(2)(i)(F) of this section are effective for taxable years beginning on or after the date of publication of the Treasury Decision adopting those rules as final regulations in the **Federal Register**.

Robert E. Wenzel,
*Deputy Commissioner of
Internal Revenue.*

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